

S
368.41
W20r
2002

STATE DOCUMENTS COLLECTION

SP 2 2003

MONTANA STATE LIBRARY
2905 E. 3RD AVE.
HELENA, MONTANA 59620

ONE VISION
FOR MONTANA

MONTANA STATE FUND ANNUAL REPORT 2002





3 0864 0014 9042 7

OUR MISSION MONTANA'S INSURANCE CARRIER OF CHOICE AND

CONTENTS

- 01 Letter from the Chairman of the Board 02 04 Letter from the President 05 07 2002-The Year in Review
13 2002 Key Financial Highlights Montana State Fund Facts 14 26 Financials 27 28 Auditor and Actuarial Letters
Inside back cover Report of Management; Board of Directors / Executive Staff



A MESSAGE FROM
THE CHAIRMAN



On behalf of the Board of Directors, it gives me great pleasure to share with you the accomplishments of Montana State Fund for FY 2002. Throughout the past year, the insurance market nationally coped with price increases to customers, declining investment income and increased losses.

In this type of business environment, a competitive state fund must be a stabilizing force in the marketplace. It is of paramount importance to the businesses in Montana that there is a reliable, stable workers' compensation system in place for this essential and mandatory coverage. Montana State Fund is that organization. We understand the critical role we play in the economic and social well being of the citizens of our state. It is a responsibility that we gladly accept, and it's what separates us from the other insurance carriers that operate in Montana.

By maintaining our financial strength and stability, we continue to deliver the highest quality workers' compensation insurance at competitive prices. Through partnerships with our stakeholders, we have improved our service to our customers. Montana State Fund is a dynamic organization that is constantly fine tuning itself to maintain our status as Montana's insurance carrier of choice and industry leader in service.

Thanks to our employees, agents, and, most importantly, our policyholders for making 2002 another successful year. I would also like to thank the Board members for their commitment to the people of Montana. The Board and staff of the Montana State Fund comprise a great team, and it's a pleasure to be able to serve with all of you.

A handwritten signature in black ink, appearing to read "Herbert Leuprecht".

Herbert Leuprecht, Chairman





We have protected Montana businesses through a depression, two world wars and 81 Cat - Griz games. Montana is our home, and we are here to serve the people of our state.

A MESSAGE FROM THE PRESIDENT

By any measure, 2002 was a challenging year for workers' compensation insurers. The combination of rising medical costs, decreased investment income, higher reinsurance rates, and increases in claim losses has resulted in declining profits and upward pressure on pricing. Nationally, insurance carriers are still coming to grips with the aftershocks of the tragic events of 9/11 and the impacts that continue to ripple through our economy.

Positive Results in a Difficult Market

Montana comprises a mere 4/10ths of 1% of the national workers' compensation market. When times get tough in the insurance industry, carriers often find it necessary to concentrate their resources in their core markets. In the past several years, carriers withdrew from our state, leaving Montana businesses with fewer options for purchasing workers'

compensation coverage. During times like these, the role of a competitive state fund takes on even greater significance. Montana State Fund (MSF) exists to provide all businesses with competitively priced coverage and top-of-the-line service. We have protected Montana businesses through a depression, two world wars and 81 Cat - Griz games. Montana is our home, and we are here to serve the people of our state.

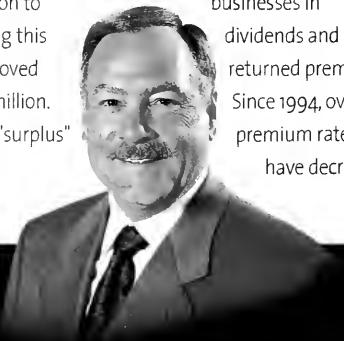
During FY02, we saw our net earned premium grow by 24.8%, exceeding \$92 million. Our investment income for the period once again showed an increase by topping \$33 million for the year. Given the turmoil in the financial markets, we do not expect to sustain these results into the future. Loss reserves increased \$20.5 million to \$346.4 million. During this same time, we improved our surplus by \$7.6 million. Often referred to as "surplus" in the insurance

industry, it is really a contingent liability fund. While surplus generates investment income that benefits our policyholders on their pricing, it also serves as a reserve for any future loss contingencies. By maintaining adequate reserves and a strong surplus based on insurance industry best practices, we continue to be a strong and long-term viable carrier, committed to Montana businesses.

For the fourth consecutive year, our Board of Directors was able to declare a dividend for our eligible policyholders with superior safety records.

In light of the challenges facing the insurance industry, this is a significant result. Since 1998, \$28 million has been given back to Montana

businesses in dividends and returned premiums. Since 1994, overall premium rates have decreased



in Montana by 38%. Due to the market conditions outlined above, as well as recognizing an additional \$9 million in adverse lost development in FY02, we found it necessary to increase our rates by a modest amount. I anticipate that for the near term, this trend will continue as we cope with the challenges confronting all workers' compensation carriers. For now, employers need to recognize that prices for coverage will increase. It therefore becomes incumbent on all of us to do what we can to prevent accidents in the workplace. By increasing our investment in safety management through stationing our consultants across the state, and offering free safety training seminars, MSF is committed to doing all it can to reduce accidents.

Fine Tuning Our Organization

Montana State Fund has gone through numerous structural improvements since our

creation. We have transitioned from a traditional organizational configuration to one that is adapted to the needs of the insurance industry. We embarked on Phase IV of our internal restructuring that we implemented in November 2000 and are already seeing improvements in efficiencies in a number of operational areas. In our most recent policy-holders' survey, we saw a marked improvement in how our customers view MSF. As Montana's economic structure undergoes another evolutionary change, we continue to fill our critical role as the guaranteed market.

Our Vision for Montana

Our vision as an organization is that Montana State Fund is committed to the health and economic prosperity of Montana. We accomplish this by providing superior service, leadership, with caring individuals working in an

environment of teamwork, creativity and trust.

The true measure of who we are goes beyond our fiduciary responsibilities. We are Montanans, and recognize how fortunate we are to call this place our home. Montana State Fund plays a unique and important role in our state. As a public entity and the guaranteed market, we acknowledge the obligation we have to our 908,000 citizens. A well-run organization is constantly fine tuning itself, responding to the current and anticipated market environment. We will continue to make improvements to our organizational structure in order to meet the formidable challenges that lie ahead. Working closely with our Board of Directors, we will ensure that MSF is properly positioned to maintain our competitiveness in the marketplace.

By increasing our investment in safety management through stationing our consultants across the state, and offering free safety training seminars, MSF is committed to doing all it can to reduce accidents.



A MESSAGE FROM THE PRESIDENT

We exist to provide Montana employers and their employees with competitively priced coverage, and to serve them no matter what challenges face the insurance industry.

Our vision also differentiates us from other workers' compensation insurance carriers in Montana. We exist to provide Montana employers and their employees with competitively priced coverage, and to serve them no matter what challenges face the insurance industry.

Our financial stability is key in allowing us to provide Montana businesses with a viable choice for purchasing their workers' compensation coverage. Top-rated insurance companies maintain adequate reserve levels to provide protection from unanticipated losses. Since the terrorist attacks of 9/11, the costs for reinsurance nationwide have skyrocketed. For Montana State Fund, we experienced reinsurance cost increases of over 300%, with greater levels of exposure. Given these events, our strong surplus takes on even greater significance.

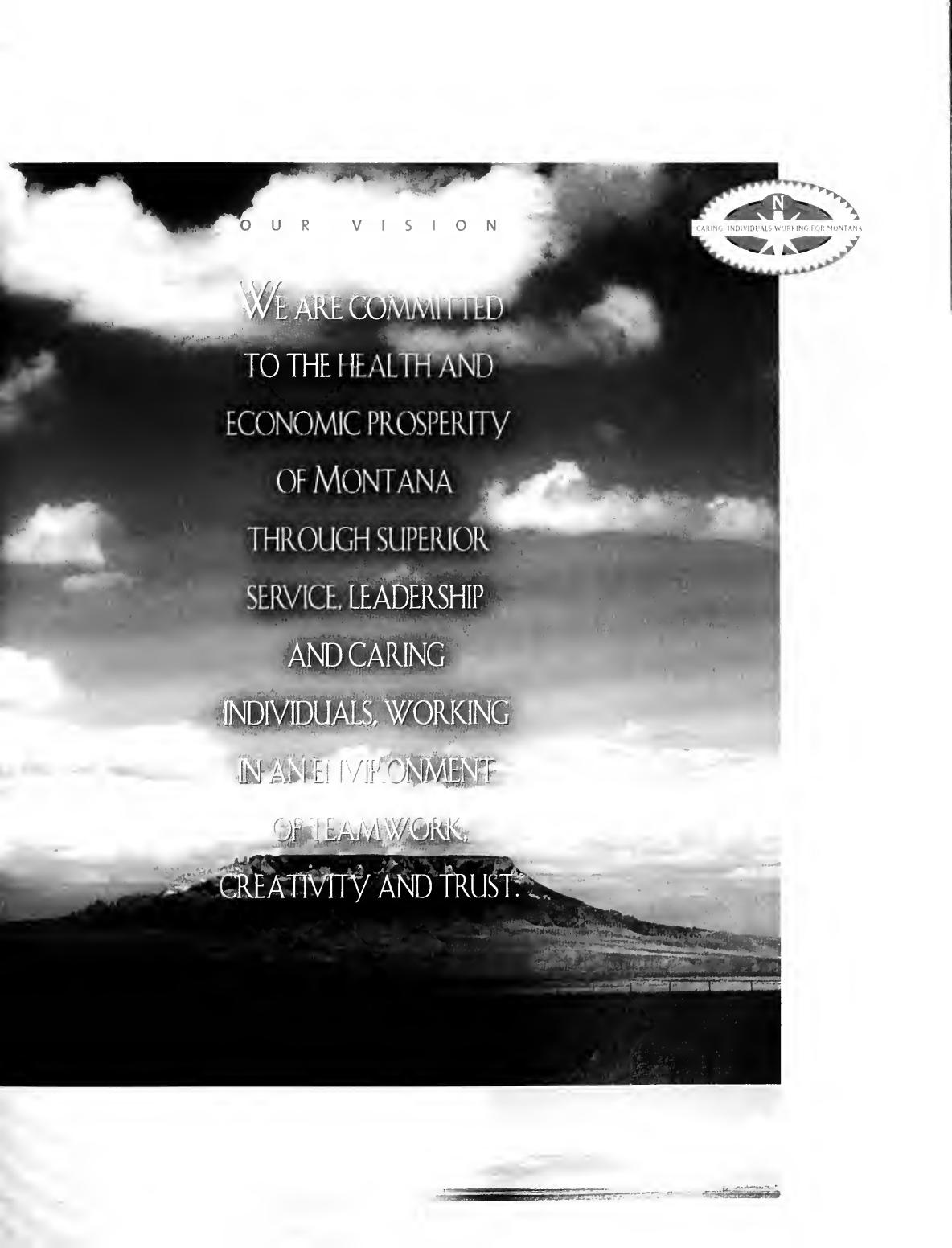
During these tough financial times, some may feel that it is appropriate to divert our policyholder surplus to the General Fund. The integrity of our surplus must be preserved. On this we are quite adamant. The role of surplus for an insurance company serves as a contingent liability fund, which safeguards policyholders and injured employees from adverse developments. These funds should only be used for the purposes for which they were collected. We are taking a leadership role in protecting the interests of our 26,000+ customers and the thousands of injured employees we serve on an annual basis. They have put their trust in us, and we will vigorously oppose any attempt to redirect these funds for other purposes. We know costs are on the increase for workers' compensation insurance driven primarily by medical cost inflation. We do not want to

increase premiums to replace surplus used for other purposes.

We have no interest in representing other lines of insurance. Our vision focuses on our commitment, and in that we are dedicated to providing the best possible workers' compensation coverage in Montana.

By fostering an environment that focuses on creativity and trust, we truly have become the insurance carrier of choice and industry leader in service in Montana. Our greatest satisfaction comes from the knowledge that by working together we have been able to make a difference to the people who we serve.


Carl Swanson, President/CEO



OUR VISION



WE ARE COMMITTED
TO THE HEALTH AND
ECONOMIC PROSPERITY
OF MONTANA
THROUGH SUPERIOR
SERVICE, LEADERSHIP
AND CARING
INDIVIDUALS, WORKING
IN AN ENVIRONMENT
OF TEAM WORK,
CREATIVITY AND TRUST.

We deal with injured employees on a daily basis. We know what it means when an individual can't work due to an unfortunate accident. That's why we have redoubled our efforts to help employers identify and eliminate the causes of accidents before they happen. There is no substitute for workplace safety. Because unsafe behavior contributes to more than 90% of all injuries, it's essential that businesses commit themselves to promoting the development of a safety culture in their organization.

Montana State Fund has taken a proactive approach to provide employers with the best possible training and information available. We know that a safe working environment contributes to a company's overall success and the well-being of employees. One of the key factors that can help control rising insurance costs is an investment in workplace safety. That's why we offered 36 free safety workshops in FY02 across the state to give employers the training they needed to develop safety programs tailored to fit their needs. Our workshops are open to any employer, not just MSF policyholders. The safety and welfare of all Montana workers is our primary concern.

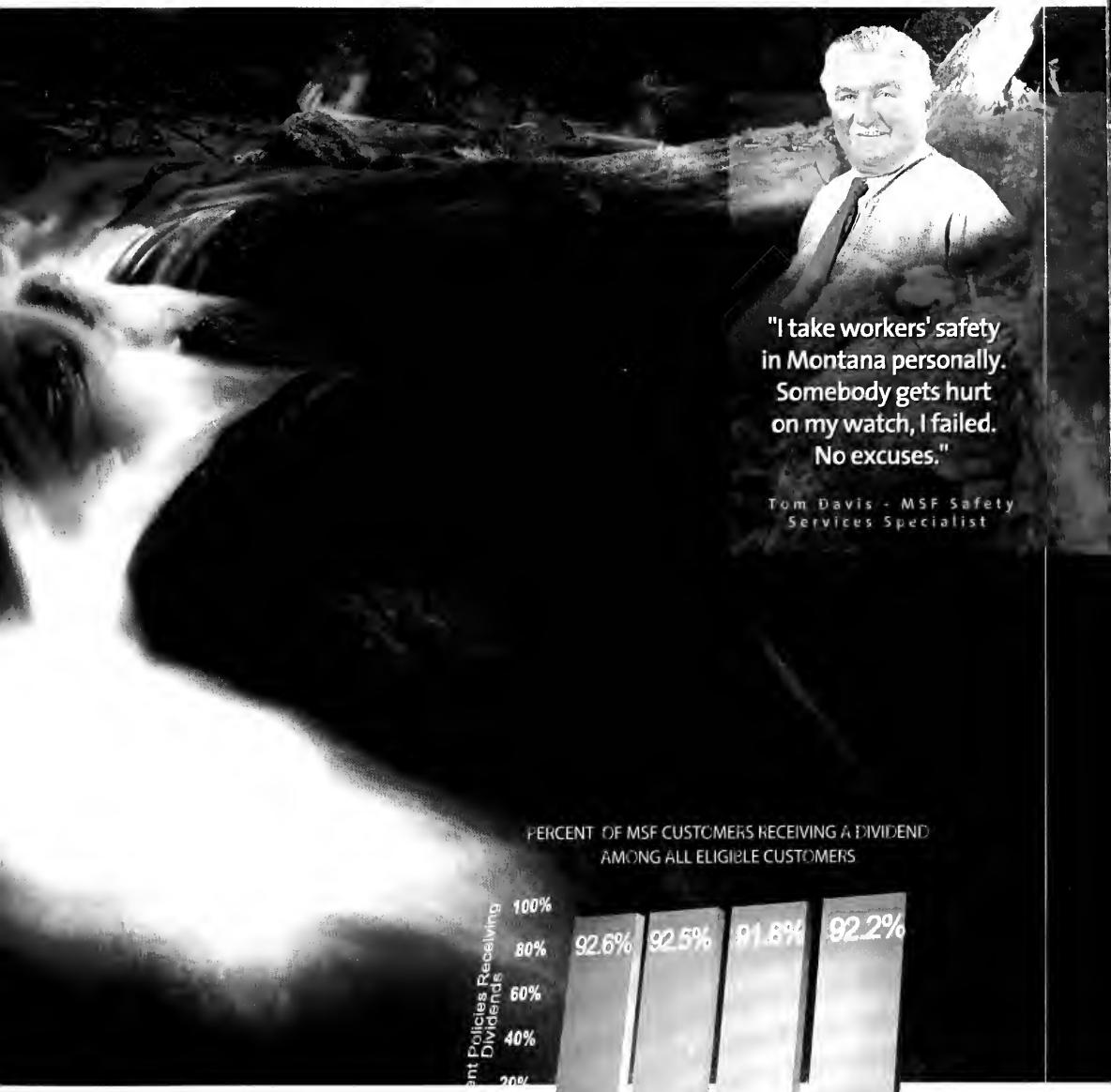
This year we were also able to declare our fourth consecutive dividend for qualifying policyholders. This is money that stays in Montana and is put back to work in our communities. At the same time, we strengthened our surplus and reserves so we can continue to operate as a long-term viable insurance carrier committed to the businesses in our state. A financially strong and stable Montana State Fund contributes to the growth and economic prosperity of Montana.

Rich Daniels - Injured Employee - Missoula, MT

"I know this might sound cliché, but my MSF claim adjuster makes me feel like a person, not a number."



PROSPERITY



"I take workers' safety in Montana personally. Somebody gets hurt on my watch, I failed. No excuses."

Tom Davis - MSF Safety Services Specialist

PERCENT OF MSF CUSTOMERS RECEIVING A DIVIDEND AMONG ALL ELIGIBLE CUSTOMERS



Montana State Fire Insurance Company has been providing insurance coverage to the state's coal industry since 1919. Our independent insurance company is a member of the Montana Department of Labor's Workers' Compensation Fund. We offer insurance products to support the coal industry and the communities it serves.



"It's important to me and my employees that we can speak with Montanans when we need help understanding our state's workers' compensation insurance program. Montana State Fund has made great strides over the years to improve their customer service. We appreciate their determination and dedication to Montana businesses."

Maria Durbin - Wickens Construction Incorporated - Policyholder - Lewistown, MT



"I take the mystery and confusion out of workers' compensation insurance for my policyholders and injured employees by building a trust between Montana State Fund and our customers."

Lynn Mogstad - MSF
Customer Service
Specialist Team



LEADERSHIP



MSF has also gone to great lengths to improve policyholder communications. In FY02 we undertook a total redesign of our newsletter to make it more current and relevant to their needs. As 88% of our customers have Internet access, we've made significant improvements to our web site, giving customers access to MSF programs and services on a 24/7 basis. Based on feedback, we took a comprehensive approach to redesign our letters and brochures to make them easier to understand and more "user friendly."

Our partnership with independent Montana insurance agents continues to grow. Policyholders report that their agent's knowledge of workers' compensation and how it affects their business is critical to their overall satisfaction. By teaming up with these qualified professionals, MSF is able to provide a level of service that is unmatched in the industry.

We have also improved efficiencies in a number of operational areas and have made a major investment in our safety management services. As Montana's economic structure undergoes another evolutionary change, we continue to fill our critical role as the guaranteed market.

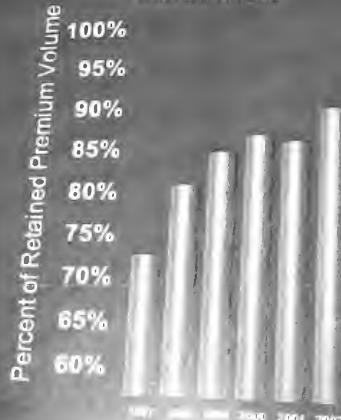
In a recent survey conducted by an independent consulting firm, we've seen a dramatic improvement in policyholder satisfaction levels in key areas of our organization. While we're proud of our accomplishments, service is only as good as the last customer contact. On the corporate level, we directed our energies to creating an environment in which our customer service maintains consistency in handling policy matters, responds to questions and requests in a timely manner, with courteous and knowledgeable front-line staff who are easily accessible.

And our customers are telling us that it's working, with nearly 9 out of 10 saying they are satisfied with the MSF staff member they deal with most often. We know that our policyholders need to juggle a lot of responsibilities. Our goal is to provide them with service that is unparalleled in the industry. With a policyholder retention level now exceeding 95%, we know we're on the right track.

In the early months of 2002, we began to see a positive trend in policyholder retention rates. However, the most significant growth has been in 2002. MSF is continuing to work hard to maintain and improve our leadership position.

PREMIUM RETENTION RATE

Valued as of 10/1/2002



AGENT-REPRESENTED BUSINESS
TOTAL WRITTEN PREMIUM

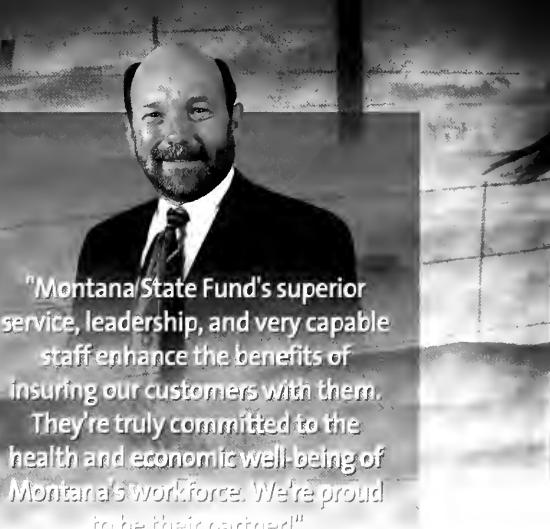


AGENT-REPRESENTED BUSINESS
Valued as of 10/1/2002



Montana State Fund's business represented by independent agents and brokers ("agent-represented business") has grown steadily over the last four years. This growth is driven by our agents and brokers' ability to offer customers benefitting from insurance products and services that fit their unique needs and help them manage their insurance costs.

Focusing an organization's energy towards a common purpose produces powerful results. At Montana State Fund, we attribute our ongoing success to our strategic planning process. Each and every year we undergo an organizational review, looking for improvements and new ways in which we can provide services to our customers. Our strategic planning process is at the very core of our organization. We've learned to imagine what we want our future to be, and identify the steps to get us there. In many ways, our planning process is



"Montana State Fund's superior service, leadership, and very capable staff enhance the benefits of insuring our customers with them. They're truly committed to the health and economic well-being of Montana's workforce. We're proud to be their partner!"

Mark Nicholls - President - Flynn
Insurance Agency - Great Falls, MT

TEAMWORK & CREATIVITY



similar to architectural blueprints for our company.

When architects make drawings of a building, they are helping people imagine exactly what that building will look like. The more precise their drawings, the more completely they can "see" the building. It is incumbent upon any organization to face their challenges with a clear understanding of the tasks at hand, develop a blueprint for improvement, and follow through with well-planned and measurable actions. Montana State Fund consists of 250 dedicated individuals who work together as a team to achieve significant results.



Sandra Clark



FIGURE 2

HIGHLIGHTS & FACTS

When we went live with our corporate restructure in November 2000, our employees were empowered to make the appropriate decisions for our customers. At that time we hired Ipsos-Reid, an internationally renowned research firm to complete an independent baseline study on policyholder satisfaction. Our plan was to measure the impact of our corporate redesign objectively with a follow up survey.

We're proud to report that in the recent follow up survey, Ipsos-Reid found that "significant improvements in satisfaction have occurred in many areas related to policyholder satisfaction. Importantly, most of these improvements are in areas that drive overall policyholder satisfaction and few significant declines emerge." The most notable changes include:

- A strong majority (87%) of policyholders are satisfied with the overall service provided by the MSF staff member they deal with most often.
- Strong satisfaction is voiced for the staff's courteousness (95%), their knowledge of workers' compensation insurance (91%, improved significantly from 84% in 2000), the timeliness of responses (81%), and the hours policyholders can access the staff (80%).
- Policyholders place a high degree of importance on having a dedicated team of representatives (81%).
- Policyholders maintain the view they held two years ago that MSF is better than other private insurance providers with respect to customer service (60% say MSF is better - significantly increased from 49% in 2000).
- Policyholders' views towards MSF have significantly improved over the past two years (from 68% in 2000 to 77% in 2002).
- Improvements have occurred relative to the accessibility of MSF representatives (81%, increased from 68% in 2000), and to the willingness to recommend MSF insurance to other businesses (72%, increased from 60% in 2000).

These are results we are proud of, and reinforce our position as Montana's insurance carrier of choice and industry leader in service.

AS OF JUNE 30, 2002

Earned Premium	\$92,971,868
Number of Policies Serviced	26,747
Total Number of Claims Processed	12,080
Number of FTEs	251
Investment Income	\$29,112,843
Net Income	\$7,793,283
Reserve to Surplus Ratio (after dividend)	2.19
Premium to Surplus Ratio (after dividend)	0.59
Equity	\$158,498,995
Total Fraud Savings Since Inception	\$12,812,274

Redesigned with a fresh new look, our quarterly newsletter provides timely and useful information on workers' compensation issues in Montana.

Available in either print or electronic format,

Perspectives is distributed

to over 30,000

policyholders, medical

providers, insurance

agents, and other

interested parties.





The 2001 Legislature gave us the ability to establish a charitable giving program to promote civic goodwill and enhance the success of selected worthwhile causes in Montana. In response, we created our ACE (Assist Charitable Endeavors) program. ACE makes matching funds available to qualifying non-profit organizations and programs that contribute to both safety and community well being in our state. In FY02, 11 grants totaling \$16,000 were awarded. We appreciate the backing we have received from both the legislature and our Board of Directors to allow us to lend a helping hand in our communities for deserving projects. It gives us the chance to be the good corporate citizens that we need to be.

Recognizing that education is the key to Montana's future, we also established a Scholarship program to assist children and spouses of workers who were fatally injured in a work-related accident. While nothing can replace the untimely loss of a loved one, it is our hope that these awards for higher education may help fulfill the aspirations of those whose lives have been disrupted.

Montana State Fund plays a unique and important role in Montana. As a public entity, we acknowledge the obligation we have to the citizens of our state and believe that this scholarship program allows us to provide an additional benefit for those who are most affected by such a significant loss.

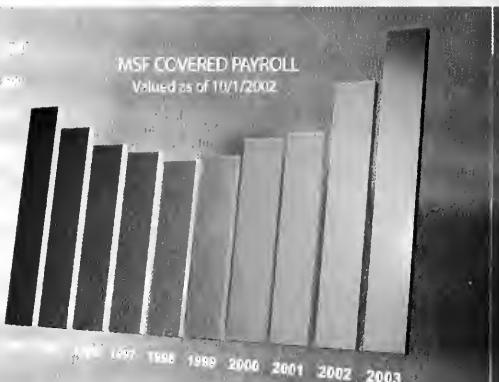
The true measure of who we are goes beyond our fiduciary responsibilities. We are Montanans, and recognize how fortunate we are to call this place our home. Our employees are active and involved, giving freely of their time and resources to improve our communities. As we move forward, this vision will be our guide.



TRUST

FINANCIAL SECTION

Our finances are carefully scrutinized by independent outside actuaries and then reviewed by independent certified public accountants. In our role as a competitive state fund, we also receive an annual audit from the legislative fiscal audit division on both our business practices and finances. No other insurance carrier in our state receives as thorough an examination as we do. Our financial integrity is unquestioned, and serves as the cornerstone of our operation. We have an obligation to those in Montana who have placed their trust in us to provide quality coverage, both today and into the future. Montana State Fund's board and management have taken a leadership role by instituting insurance industry best practices along with strict internal quality assurance programs to maintain the integrity of all that we do.



MSF covered payrolls had declined from approximately \$3.1 billion in 1994 to \$2.2 billion in 1998. Since 1998, the amount of payroll being covered by MSF has significantly risen as market conditions have changed and MSF has established itself as an industry leader in customer service and product quality. MSF will cover an estimated \$3.7 billion in employer payroll in 2003.

**STATUTORY STATEMENTS OF ADMITTED ASSETS,
LIABILITIES, AND SURPLUS**

as of June 30,

A D M I T T E D A S S E T S

	2002	2001
INVESTMENTS		
Bonds	\$415,322,318	\$421,916,311
Equity Securities	64,180,639	23,703,663
Cash and Short-Term Investments	22,034,873	31,029,459
Other Investments - Collateral Securities on Loan	57,563,169	88,689,281
Total Investments and Cash	<u>559,100,999</u>	<u>565,338,714</u>
OTHER ADMITTED ASSETS		
Premium Receivables	7,365,247	18,563,696
Equipment (net)	842,983	944,602
Interest Receivable	6,441,102	7,163,948
Other Assets	1,173,510	1,462,178
Total Admitted Assets	<u>\$574,923,841</u>	<u>\$593,473,138</u>

L I A B I L I T I E S A N D S U R P L U S

LIABILITIES		
Losses Incurred Reserves	\$308,700,000	\$289,988,342
Loss Adjustment Expense Reserves	37,700,000	35,911,658
Liability for Securities on Loan	57,563,169	88,689,281
Deferred Revenue	583,980	16,157,343
Other Liabilities	11,877,697	11,846,975
Total Liabilities	<u>416,424,846</u>	<u>442,593,599</u>

CONTINGENCIES AND SUBSEQUENT EVENTS

SURPLUS		
Policyholders' Surplus	158,498,995	150,879,539
Total Liabilities and Surplus	<u>\$574,923,841</u>	<u>\$593,473,138</u>

The accompanying notes are an integral part of these financial statements.

F Y 2 0 0 2 A S S E T S

- Bonds 73%
- Equity Securities 11%
- Cash & Short-Term Investments 4%
- Other Investments 10%
(collateral securities on loan)
- Premium Receivable 1%
- Equipment, Interest Receivable
& Other Assets 1%



F Y 2 0 0 2 L I A B I L I T I E S & S U R P L U S

- Losses Incurred 53%
- Loss Adjustment Expense 7%
- Payables for Securities on Loan 10%
- Deferred Revenue 1%
- Other Liabilities 2%
- Policyholders' Surplus 27%



**STATUTORY STATEMENTS OF OPERATIONS
AND CHANGES IN SURPLUS**

for the years ended June 30,

	2002	2001
Net Premium Earned	\$92,971,868	\$74,510,374
Losses Incurred	(86,699,328)	(71,606,236)
Loss Expenses Incurred	(12,883,989)	(11,590,179)
Underwriting Expenses Incurred	<u>(15,024,225)</u>	<u>(12,956,586)</u>
Net Underwriting Loss	<u>\$21,635,674</u>	<u>\$21,642,627</u>
Net Investment Income Earned	29,112,843	31,519,273
Net Realized Capital Gains (Losses)	4,351,624	2,123,631
Premium Balances Recovered (Charged Off)	(445,304)	(465,502)
Other Income	<u>411,018</u>	<u>46,985</u>
Net Income Before Dividends	<u>11,794,507</u>	<u>11,581,760</u>
Policyholder Dividends	<u>(4,001,224)</u>	<u>(4,995,259)</u>
Net Income After Dividends	<u>7,793,283</u>	<u>6,586,501</u>
Prior Year End Surplus	150,879,539	138,768,376
Net Unrealized Gains (Losses) on Equity Securities	(9,523,024)	(296,337)
Change in Nonadmitted Assets	4,223,294	(903,501)
Cumulative Effect of Change in Accounting Principle		
Due to Codification	(2,242,469)	0
Aggregate Write In for Gains (Losses) in Surplus	(14,140)	(40,527)
Transfer In, net	<u>7,382,512</u>	<u>6,765,027</u>
END OF PERIOD SURPLUS	<u>\$158,498,995</u>	<u>\$150,879,539</u>

The accompanying notes are an integral part of these financial statements.

F Y 2 0 0 2 E X P E N S E S & T R A N S F E R S

- Losses Incurred 69%
- Loss Expenses Incurred 10%
- Underwriting Expenses Incurred 12%
- Policyholder Dividends 3%
- Transfers In and Other 6%



F Y 2 0 0 2 R E V E N U E

- Premiums 76%
- Investment, Realized Gains/Losses and Other Income 24%

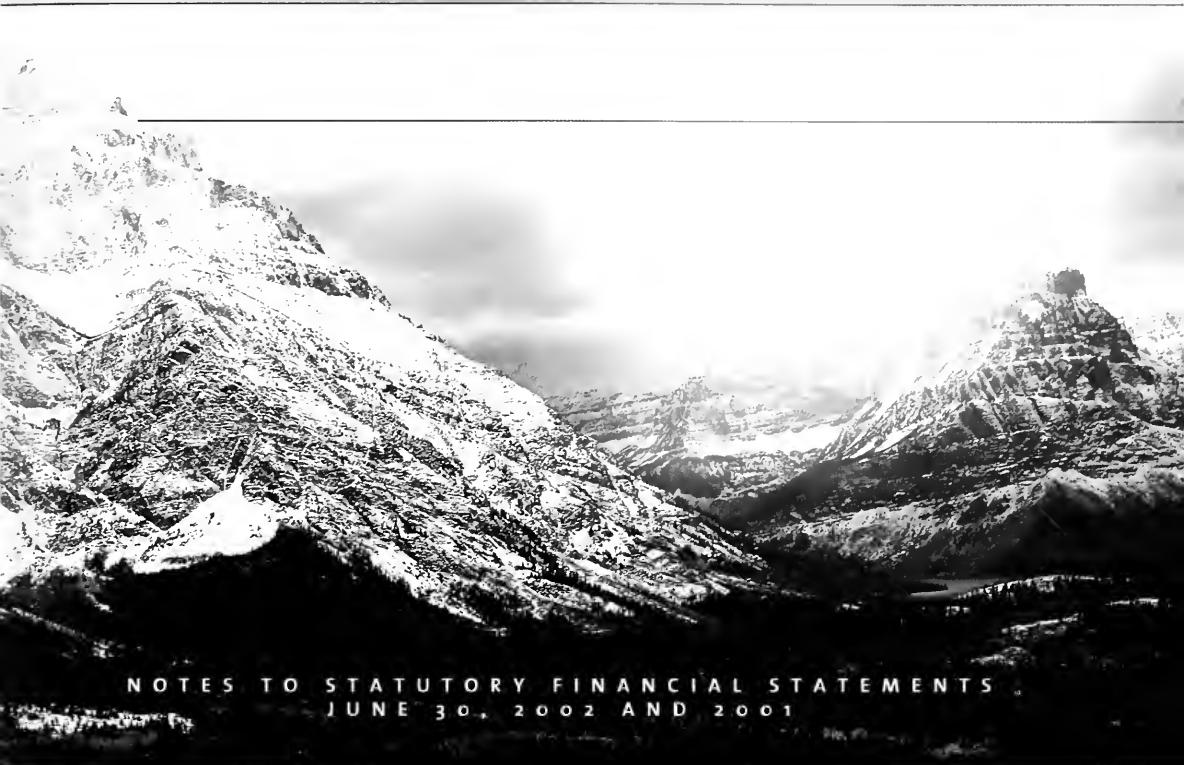


STATUTORY STATEMENTS OF CASH FLOWS

for the years ended June 30,

	2002	2001
CASH FLOWS FROM OPERATIONS		
Premiums Collected Net of Reinsurance	\$104,398,909	\$69,776,324
Loss and Loss Adjustment Expenses Paid	(79,083,317)	(72,196,414)
Underwriting Expenses Paid	(14,033,481)	(11,813,895)
Cash Used For Underwriting	<u>11,282,111</u>	<u>(14,233,985)</u>
Net Investment Income	29,922,768	31,612,594
Other Income (Expenses):		
Agents' Balances Charged Off	(445,304)	(465,502)
Net Funds Held Under Reinsurance Treaties	(36,000)	(37,000)
Net Amount Withheld or Retained for Account of Others	(1,390,484)	4,387,758
Miscellaneous Income (Expense)	<u>(30,715,094)</u>	<u>46,985</u>
Total Other Income	<u>(32,586,882)</u>	<u>3,932,241</u>
Dividends to Policyholders	(4,001,224)	(4,995,259)
Net Cash Provided by Operations	<u><u>4,616,773</u></u>	<u><u>16,315,591</u></u>
CASH FLOWS FROM INVESTMENTS		
Proceeds from Investments Sold, Matured or Repaid:		
Bonds	151,192,132	134,583,457
Change in Collateral Securities	<u>31,126,112</u>	<u>11,490,960</u>
Total Investment Proceeds	<u>182,318,244</u>	<u>146,074,417</u>
Cost of Investments Acquired (long-term only):		
Bonds	(141,521,244)	(134,605,307)
Stock	<u>(50,000,000)</u>	<u>(24,000,000)</u>
Cost of Investment Acquired	<u>(191,521,244)</u>	<u>(158,605,307)</u>
Net Cash Used For Investments	<u><u>(9,203,000)</u></u>	<u><u>(12,530,890)</u></u>
CASH FLOWS FROM FINANCING AND MISCELLANEOUS SOURCES		
Cash Provided:		
Changes in Surplus	10,726,844	8,443,590
Transfers from Affiliates	<u>438,160</u>	-
Cash Applied:		
Transfers to Affiliates	-	(1,028,308)
Other Applications	<u>(15,573,363)</u>	<u>(10,123,494)</u>
Net Cash Used for Financing and Miscellaneous Sources	<u><u>(4,408,359)</u></u>	<u><u>(2,708,212)</u></u>
NET INCREASE (DECREASE) IN CASH AND SHORT TERM INVESTMENTS	<u><u>(8,994,586)</u></u>	<u><u>1,076,489</u></u>
CASH AND SHORT TERM INVESTMENTS - BEGINNING OF YEAR	<u><u>31,029,459</u></u>	<u><u>29,952,970</u></u>
CASH AND SHORT TERM INVESTMENTS - END OF YEAR	<u><u>\$22,034,873</u></u>	<u><u>\$31,029,459</u></u>

The accompanying notes are an integral part of these financial statements.



**NOTES TO STATUTORY FINANCIAL STATEMENTS
JUNE 30, 2002 AND 2001**

**NOTE A – ORGANIZATION, BASIS OF PRESENTATION,
AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

1. Organization

The Montana State Fund (MSF) is a nonprofit, independent public corporation established under Title 39, Chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is a component unit of the State of Montana. MSF is attached to the State of Montana, Department of Administration for administrative purposes only. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the State of Montana.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are

separate and distinct from assets, debts, and obligations of the State of Montana. State law requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA).

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund (MSF). This report reflects only the operations of the Montana State Fund (New Fund only). MSF administers and manages the remaining claims of the Old Fund on behalf of the State of Montana and receives an administrative fee.

State law requires that any excess surplus in the Old Fund above an amount deemed as adequately funded by state law up to \$63.8 million be transferred to the Montana State Fund. However, during the State of Montana Special Legislative session in August 2002, Senate Bill 19 was passed which impacts this transfer. See Note J (Contingencies, Uncertainties and Subsequent Events) for further discussion.

A. Basis of Presentation

Montana State Fund prepares its statutory financial statements in conformity with the accounting practices prescribed or permitted by the State of Montana. Effective January 1, 2001, the State of Montana required that insurance companies domiciled in the State of Montana prepare their statutory basis financial statements in accordance with the National Association of Insurance Commissioners (NAIC) "Accounting Practices and Procedures Manual (APPM) – Version effective January 1, 2001" subject to any deviations prescribed or permitted by the State of Montana insurance commissioner. The APPM includes the Statements of Statutory Accounting Principles (SSAPs), the preamble and the appendices.

The APPM is not intended to preempt states' legislative and regulatory authority. It is intended to establish a comprehensive basis of accounting recognized and adhered to in absence of, conflict with, or silence of, state statutes and/or regulators. Accounting changes adopted to conform to the NAIC are reported as changes in accounting principles and are reported as an adjustment to unassigned surplus in the period of the change in accounting principle. As a result of these changes, MSF reported a change of accounting principle as an adjustment that decreased unassigned surplus of \$2,242,469 as of July 1, 2001.

The Montana Code Annotated references conformity with the Accounting Practices and Procedures Manual within section 33-2-701(1) and therefore concludes that no legislation is necessary to adopt its use.

The State of Montana has adopted certain prescribed accounting practices that differ from those found in NAIC SAP.

There is no difference in MSF's net income, capital and surplus between NAIC SAP and the practices prescribed and permitted by the State of Montana.

B. Accounting Policies

Cash and Cash Equivalents - Cash constitutes a medium of exchange that a bank or other similar financial institution will accept for deposit and allow an immediate credit to the depositor's account. Also classified as cash are savings accounts, certificates of deposits with maturity dates of one year or less, and cash equivalents. Cash

equivalents are: investments with original maturities of three months or less; are readily convertible to known amounts of cash; and, present insignificant risk of change in value due to changes in interest rates. The Montana State Treasury holds MSF's cash and cash equivalent balances.

Short-term Investments - Short-term Investments are those investments with remaining maturities of one year or less at the time of acquisition, excluding those investments classified as cash equivalents. Short-term investments include but are not limited to, bonds, commercial paper, money market instruments, repurchase agreements, and collateral and mortgage loans that meet the above criteria. Short-term investments shall not include certificates of deposit.

Premium Receivable - SSAP 6 in the APPM requires premium receivable balances with an amount due over 90 days to be nonadmitted assets and charged to surplus. In addition, the new SSAP guidance requires that the remaining admitted accounts receivable asset be reviewed for impairment. If it is probable the balance is not collectible, the uncollectible receivable shall be written off and charged to income in the period the determination is made.

As of June 30, 2002 the billing practices were changed and the July billing, typically a large billing, occurred on July 1, 2002 rather than on June 1, 2002. This change in billing procedure resulted in a significant reduction in premiums receivable balances from the year ended June 30, 2001, in which the July billing took place on June 1, 2001.

Risks and Uncertainties - SSAP 1 requires disclosures of risks and uncertainties existing as of the date of the financial statements, as follows:

Use of Estimates - The preparation of financial statements in conformity with Statutory Accounting Principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates.

Loss and LAE Reserves - Loss and loss adjustment expense (LAE) reserves (estimated claims payable) are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are based on individual claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported claims, as determined by management in conjunction with an independent consulting

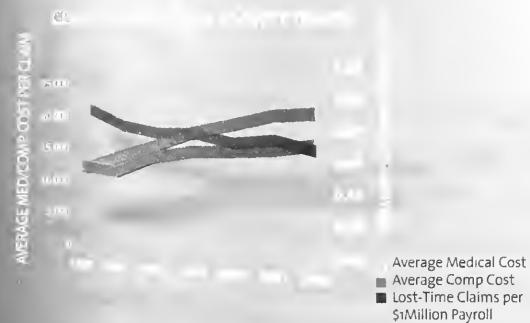
actuary. Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustment to these estimates of reserves will be reflected in the Statutory Statement of Operations in future years.

Uncertainty Due to Litigation - In the ordinary course of business, MSF is a defendant in various litigation matters. Although there can be no assurances, as of June 30, 2002 and 2001, in the opinion of MSF's management based on information currently available, the ultimate resolution of these legal proceedings would not be likely to have a material adverse effect on its statutory results of operations, financial condition or liquidity.

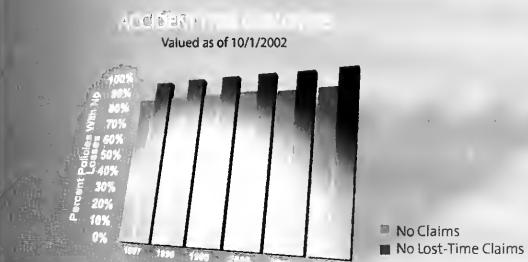
Vulnerability Due to Certain Concentrations - MSF used approximately 48 agencies located throughout Montana to write workers compensation policies with gross written premiums of \$53,664,639 for the year ended June 30, 2002. MSF conducts its business within the State of Montana for the most part and is susceptible to risk based on the economy of the geographic territory it serves.

Administrative Cost Allocation - State law requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to \$1,250,000 for fiscal year 2002 and 2001, respectively. The Montana State Fund allocated \$1,250,000 in administration costs to the Old Fund in fiscal years 2002 and 2001, respectively. The Old Fund has a \$1,018,527 contingent obligation to the Montana State Fund in unrecovered administrative costs incurred in fiscal years prior to 2001-2002, consequently, it is not recorded on these financial statements. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted \$1,250,000.

Long-Term Securities - Long-term securities consist of equity securities and bonds. Long-term securities are held by the Montana Board of Investments (BOI) and State Street Bank is the custodial bank for the BOI. Equity securities are valued at fair market value. Bonds are rated and valued in accordance with the Securities Valuation Office (SVO) rating guidelines. Bonds with a SVO rating of 1 and 2 are valued at amortized cost. Bonds with a SVO rating of 3 or higher are valued at the lower of cost or market. Bond amortization is calculated using the straight-line



Average medical and indemnity costs per claim tend to rise due to rising nominal wages, medical price inflation, and advances in medical treatments for injured employees. Counteracting these inflationary increases has been decreases in the frequency of lost-time claims. At some point, claim frequency will either stabilize or could begin increasing, causing workers' compensation rates to rise modestly. The ability of employers to maintain safe workplaces and provide for early return to work for their injured employees will help keep rates stable as we go forward.



Each year, approximately 85% of MSF customers experience no workplace injuries and approximately 95% experience no lost-time injuries. Safe workplaces reduce an employer's workers' compensation insurance premiums, prevent debilitating injuries for employees, and improve worker productivity thus enhancing our customers' bottom lines.



MSF rate levels have significantly decreased since 1994 due to improved conditions in the workers' compensation arena including lower medical inflation, declining claim frequency, and statutory benefit changes beginning in 1996. MSF rate levels have since stabilized and are now moderately rising with the general rate of inflation.

method. In accordance with SSAP 26, bond amortization shall be calculated using the scientific (constant yield) interest method. MSF is not able to obtain this information from its fund manager at this time. Management believes the difference between the straight-line method and the scientific method is immaterial to the current year Statutory Statements of Operations and Changes in Surplus and is not able to determine the cumulative impact to the Statutory Statements of Admitted Assets, Liabilities and Surplus. MSF has no derivative investments.

Electronic Computer Equipment and Software - Electronic computer equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of three years. Equipment is capitalized if the actual or estimated historical cost exceeds \$5,000. Software is amortized on a straight-line basis using a three-year life for operating software and a five year life for application software.

Furniture, Equipment and Leasehold Improvements - Furniture and equipment are recorded at cost and depreciated on a straight-line basis using estimated useful lives, which range from 5 to 10 years. There are no leasehold improvements to property owned by the State of Montana and used by MSF requiring amortization. SSAP 16 requires that furniture, fixtures, equipment and leasehold/property improvements be capitalized, depreciated and nonadmitted.

Losses Incurred and Loss Adjustment Expense Estimates - Tillinghast-Towers Perrin, an actuarial firm independent from MSF, prepared an actuarial study of estimated liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported for MSF as of June 30, 2002 and 2001. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors.

A provision for inflation and the calculation of estimated future claim costs is implicit in the calculation because reliance is placed both on actual historical data that reflect past inflation and on other factors that are considered to be appropriate modifiers of past experience. As of June 30, 2002 and 2001, \$346,400,000 and \$325,900,000, respectively, of unpaid claims and claim adjustment expenses are presented at face value net of estimated reinsurance recoverable.

Reinsurance Recoverables on Paid and Unpaid Losses - Reinsurance recoverables are estimates of paid and unpaid losses collectible from MSF's reinsurers. The amounts ultimately collected may be more or less than these estimates. Any adjustments of these estimates are reflected in income, as they are determined.

Deferred Revenue - Deferred revenue reflects amounts billed or received in advance, but not yet earned for policies effective July 1, 2002 and 2001, respectively.

Other Liabilities consist of:

- **Security Deposits** - Security deposits are monies held on behalf of certain insured's due to their loss ratios and payment histories as well as due to particular payment terms. In addition, funds withheld per the reinsurance contract are also included in this account.

- **Accounts Payable** - Accounts payable includes liabilities incurred on behalf of claimants, refunds due to policyholders and amounts due to vendors.

- **Compensated Absences** - MSF supports two leave programs, the State of Montana Leave Program and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers all union represented employees. Union represented employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to nonexempt employees. MSF Personal Leave Program covers all non-union employees. Non-union employees accumulate personal leave and extended leave. MSF pays employees 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination. MSF absorbs expenditures for termination pay in its annual operational costs. MSF had a total leave accrued liability of \$1,269,788 and \$1,161,284 at June 30, 2002 and 2001, respectively.

Income Taxes Payable - MSF is a component unit of the State of Montana and is not subject to Federal or State income tax or State premium tax.

Premium Revenue - Premiums are recognized as revenue on a pro-rata basis over the policy period, beginning on the effective date of the policy. Advance premiums are deferred until the effective date of the policy at which time they are recognized as revenue on a pro-rata basis over the term of the policy. MSF's Board of Directors approves premium rates annually. Revenue from premiums is recognized over the term of the policy year. Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and MSF has credited all earned premiums. Expenses incurred in connection with acquiring new insurance business, including such acquisition costs as sales commissions, are charged to operations as incurred.

Policyholder Dividends - The amount of dividends to be paid to policyholders is determined annually by MSF's Board of Directors. The aggregate amount of policyholders' dividends is related to the financial results for the year and to the appropriate level of statutory surplus to be retained by MSF.

NOTE B – INVESTMENTS

The investments of MSF as of June 30, 2002 and 2001 are as follows:

SUMMARY INVESTMENT SCHEDULE					
June 30, 2002	Gross Investment Holdings	Percentage	Admitted Assets as Reported in the Annual Statement	Percentage	
Bonds:					
U.S. treasury securities	\$ 5,006,796	0.9%	\$ 5,006,796	0.9%	
U.S. government sponsored agencies	115,788,737	20.7%	115,788,737	20.7%	
Mortgaged-backed securities:					
Pass-through securities					
Privately issued	4,658,803	0.8%	4,658,803	0.8%	
CMOs and REMICs					
Issued by FNMA and FHLMC	29,664,936	5.3%	29,664,936	5.3%	
All other privately issued	19,234,249	3.4%	19,234,249	3.4%	
Other Debt and Other Fixed Income Securities (excluding short-term):					
Unaffiliated domestic securities (includes credit tenant)					
Loans rated by the SVO	240,968,797	43.1%	240,968,797	43.1%	
Total Bonds	415,322,318	74.2%	415,322,318	74.2%	
Unaffiliated Publicly Traded Equity Securities	64,180,639	11.5%	64,180,639	11.5%	
Cash and Short-Term Investments	22,034,873	3.9%	22,034,873	3.9%	
Other Invested Assets	57,563,169	10.4%	57,563,169	10.4%	
Total Invested Assets	\$ 559,100,999	100.0%	\$ 559,100,999	100.0%	
June 30, 2001	Gross Investment Holdings	Percentage	Admitted Assets as Reported in the Annual Statement	Percentage	
Total Bonds	\$ 421,916,311	74.6%	\$ 421,916,311	74.6%	
Unaffiliated Publicly Traded Equity Securities	23,703,663	4.2%	23,703,663	4.2%	
Cash and Short-Term Investments	31,029,459	5.5%	31,029,459	5.5%	
Other Invested Assets	88,689,281	15.7%	88,689,281	15.7%	
Total Invested Assets	\$ 565,338,714	100.0%	\$ 565,338,714	100.0%	

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2002 and June 30, 2001, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The totals below are included as part of the two classifications on the Statements of Admitted Assets called "Bonds" and "Cash and Short-Term Investments."

June 30, 2002	Carrying Value	Market Value	June 30, 2001	Carrying Value	Market Value
Due one year or less (includes STIP)	\$ 27,881,557	\$ 27,898,637	Due one year or less (includes STIP)	\$ 33,067,522	\$ 33,067,522
Due after one year through five years	141,183,158	149,356,828	Due after one year through five years	164,828,051	170,332,344
Due after five years through ten years	127,324,455	132,291,958	Due after five years through ten years	125,897,300	129,727,325
Due after ten years	139,842,461	143,335,788	Due after ten years	126,740,960	127,546,734
Totals	\$436,231,631	\$452,883,211	Totals	\$450,533,833	\$460,673,925

During fiscal year ending June 30, 2002 MSF realized gross gains from sales of securities of \$6,569,674 and gross realized losses of \$2,218,050. During fiscal year ending June 30, 2001, MSF realized gross gains from sales of securities of \$2,583,238 and gross realized losses of \$459,607.

**NOTE C – CASH COLLATERAL AND LIABILITY
FOR SECURITIES ON LOAN**

Under the provisions of state statutes, the Montana Board of Investments (BOI) has, by a Securities Lending Authorization Agreement, authorized the custodial bank to lend BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the BOI's custodial bank on December 1, 1993. During the period the securities are on loan, BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain collateral equal to not less than 100% of the market value of the loaned security. BOI retains all rights of ownership during the loan period.

BOI did not impose any restrictions during fiscal years 2002 and 2001 on the amount of the loans that State Street made on its behalf.

There were no failures by any borrowers to return loaned securities or pay distributions thereon during fiscal years 2002 and 2001. There were no losses during fiscal years 2002 and 2001 resulting from default of the borrowers or State Street.

During fiscal years 2002 and 2001, BOI and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality Trust. The relationship between the average maturities of the investment pool and BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which BOI could not determine. On June 30, 2002 and June 30, 2001, BOI had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total collateral held for fiscal years 2002 and 2001:

	Fiscal Year 2002	Fiscal Year 2001
Securities on Loan - Book Value	\$52,188,972	\$80,458,558
Securities on Loan - Market Value	\$55,652,152	\$85,193,815
Total Collateral Held	\$57,563,169	\$88,689,281

NOTE D – SHORT-TERM INVESTMENTS

MSF participates in the Short-Term Investment Pool (STIP) maintained by BOI. STIP balances are highly liquid investments.

There are no legal risks that BOI is aware of regarding STIP investments. The market value of STIP approximates cost.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. BOI's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The three NRSRO's include Standard and Poor's, Moody's Investors Service and Fitch, Inc.

NOTE E – ELECTRONIC COMPUTER EQUIPMENT AND SOFTWARE

Electronic computer equipment is recorded at cost and depreciated on a straight-line basis over an estimated useful life of three years. Equipment is capitalized if the actual or estimated historical cost exceeds \$5,000. Software is amortized on a straight-line basis using a three year life for operating software and a five year life for application software.

	Equipment and Operating Software	Application Software	Total
Balances June 30, 2002			
Assets	2,157,978	8,092,119	10,250,097
Accumulated Depreciation	1,314,995	4,994,282	6,309,277
Net Assets Nonadmitted	-0-	3,097,837	3,097,837
Net Assets Admitted	842,983	-0-	842,983
Depreciation Expense	269,139	1,200,211	1,469,350
Balances June 30, 2001			
Assets	1,896,003	7,994,860	9,890,863
Accumulated Depreciation	951,401	1,979,147	2,930,548
Net Assets Nonadmitted	-0-	6,015,713	6,015,713
Net Assets Admitted	944,602	-0-	944,602
Depreciation Expense	239,020	1,056,093	1,295,113

Furniture and Equipment - Furniture and equipment are recorded at cost and depreciated on a straight-line basis using estimated useful lives, which range from 5 to 10 years.

SSAP 16 requires that furniture, fixtures and equipment be capitalized, depreciated and nonadmitted.

	Furniture and Equipment	
	<u>June 30, 2002</u>	<u>June 30, 2001</u>
Assets	936,859	869,418
Accumulated Depreciation	588,088	505,572
Net Assets Nonadmitted	348,771	363,846
Net Assets Admitted	-0-	-0-
Depreciation Expense	52,901	54,530

Building - The 1981 Legislature appropriated funds for the construction of the Workers' Compensation building. As of July 1, 1990, MSF transferred the value of the building from its records to the Department of Administration, which owns most other state

buildings. Under the agreement, MSF pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance.

Nonadmitted Assets - Certain assets designated as "nonadmitted" are excluded from the Statutory Statement of Admitted Assets. Liabilities and Surplus and the change in such assets are charged directly to unassigned surplus.

Change in Accounting Principle - During fiscal year 2002 the useful lives of computer equipment and intangible assets were permanently reduced to three and five years, respectively. As a result, a change in accounting principle of \$2,242,469 is recognized at June 30, 2002.

NOTE F – ESTIMATED CLAIMS PAYABLE

Loss and loss adjustment reserves (estimated claims payable) are established to provide for the estimated ultimate settlement cost of all claims incurred. Loss reserves are based on individual claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported claims, as determined by management in conjunction with an independent consulting actuary. Management believes that the reserves for unpaid losses and loss adjustment expenses are adequate; however, there can be no assurance that the ultimate settlement of losses may not vary materially from the estimate recorded. Since liabilities are based on estimates, the ultimate liability may be in excess of, or less than, the amounts provided. Adjustment to these estimates of reserves will be reflected in the Statutory Statement of Operations in future years.

The following analysis provides a reconciliation of the activity in the reserve for losses and loss expenses.

	Years Ended June 30, 2002		2001
At beginning of year:			
Net reserves for losses and loss expenses	\$ 325,900,000		\$ 314,900,000
Losses and loss expenses incurred:			
Current year	84,370,000		75,465,000
Prior years	5,361,000		(1,667,000)
Total	89,731,000		73,798,000
Losses and loss expenses paid:			
Current year	(16,693,000)		(14,140,000)
Prior years	(52,538,000)		(48,658,000)
Total	(69,231,000)		(62,798,000)
Total unpaid claims and claim adjustment expenses at end of the year	<u>\$346,400,000</u>		<u>\$ 325,900,000</u>

NOTE G – RETIREMENT PLANS, DEFERRED COMPENSATION AND POSTRETIREMENT PLANS

MSF and its employees contribute to the Public Employees Retirement System (PERS), a mandatory multiple-employer, cost-sharing, defined benefit pension plan administered by the State of Montana Public Employees Retirement Administration (MPERA). The PERS offers retirement, disability and death benefits to plan members and their beneficiaries. MSF and its employees each were required to contribute 6.9% of annual compensation for fiscal years 2002 and 2001. This amounted to a combined contribution of approximately \$1,400,812 and \$1,166,488, respectively. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2002 or 2001.

NOTE H – POLICYHOLDERS' DIVIDENDS

During fiscal year 2002 and 2001, the MSF's Board of Directors authorized a dividend to be paid to policyholders of record during policy years 2000 and 1999, respectively.

Payment of the dividend totaling \$4,001,224 was accomplished during May 2002 and the payment totaling \$4,995,259 was accomplished during May 2001.

NOTE I – REINSURANCE ASSUMED AND CEDED

For the fiscal years ended June 30, 2002 and 2001, MSF ceded reinsurance to other insurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against loss occurrences over stipulated amounts and an aggregate stop loss contract. The aggregate stop loss contract covered fiscal years 2002 and 2001, however the contract was commuted prior to June 30, 2002. The excess of loss contracts provide coverage of \$112,000,000 and \$87,000,000 for fiscal years 2002 and 2001, respectively. During fiscal year 2002 and 2001 MSF retained the first \$3,000,000 with a \$500,000 aggregate annual deductible for the first layer of reinsurance coverage. Individual per person coverage is provided up to \$5,000,000 per any one individual loss. In the event reinsurers are unable to meet their obligations, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

MSF purchased reinsurance coverage for Employers' Liability insurance offered to policyholders during fiscal year 2001. MSF retained the first \$200,000 in ultimate net loss for any one occurrence while reinsurers are liable for losses in excess of \$200,000 up to a limit of \$1,000,000.

As the result of commuting the aggregate stop loss contract, premium revenue is increased by \$464,760 in fiscal year 2002 due to the reversal

of the funds withheld account offsetting payments made for reinsurance coverage. Premium revenue is reduced by payments made for reinsurance coverage of \$2,951,635 in fiscal year 2001.

NOTE J – CONTINGENCIES, UNCERTAINTIES AND SUBSEQUENT EVENTS

Contingencies

Broeker v. State Fund. The issue in this case involved the way insurers calculated the social security disability offset rates on certain claims. The case was settled. The settlement provides for review of certain claims and MSF is proceeding in accordance with the terms of the settlement. The process is nearly complete.

State Compensation Insurance Fund v. George Berg, et al. This case is a pending suit against a former policyholder in which the Montana State Fund claims the policyholder failed to pay workers' compensation insurance premiums, plus interest on the unpaid premiums. The total claim was originally for \$1,046,000, but on further evaluation has been reduced to approximately \$660,000. The case was converted to a Chapter 7 liquidation. At this time, MSF is not certain how much of this claim will be recovered.

Stavenjord v. State Compensation Insurance Fund. This case addressed the issue of whether the failure of the Occupational Disease Act (ODA) to provide PPD (permanent partial disability) benefits equivalent to the benefits provided in the Montana WCA (Workers' Compensation Act) violates the claimant's right to equal protection of the law. Preliminary estimates indicate that the Stavenjord decision will increase claim costs by nearly \$1,000,000 a year for MSF. The case is currently on appeal to the Montana Supreme Court.

Subsequent Event

As discussed in Note A, excess funds from the Old Fund are transferred to MSF based on adequate funding levels in the Old Fund. During the State of Montana Special Legislative session in August 2002, Senate Bill 19 was passed. Rather than transferring the full amount of Old Fund's fiscal year 2002 excess to MSF, Senate Bill 19 allocated \$4,000,000 of the excess to the State of Montana's General Fund. The remainder is available for transfer to MSF during fiscal year 2003. The estimated total amount of excess in the Old Fund as of June 30, 2002 is \$13,177,907.

NOTE K – RECLASSIFICATIONS

Certain amounts in the prior year financial statements have been reclassified for comparative purposes to conform with the presentation in the current year financial statements.

NOTE L – UNASSIGNED SURPLUS - NON-ADMITTED ASSETS

	2002	2001
Balance of non-admitted assets - beginning of year	9,270,212	8,366,711
Increase (decrease) in non-admitted assets:		
Change in premiums receivable	(565,160)	788,228
Increase in short-term notes and loans receivable	71,011	77,985
Change in bond downgrades	(904,256)	64,573
Change in net intangible assets	(15,645)	34,836
Decrease in intangible assets	(2,917,876)	(184,915)
Increase in other assets	108,632	122,794
Net increase (decrease) in non-admitted assets	(4,223,294)	903,501
Balance of non-admitted assets - end of year	5,046,918	9,270,212

NOTE M – SUPPLEMENTAL INVESTMENT RISK INFORMATION

MSF's largest 10 exposures to a single issuer/borrower/investment, listed by investment category (excluding U.S. government-related securities) are:

	Amount	Percentage of Total Admitted Assets
Common Stock	\$ 64,180,639	11.163%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	13,636,000	2.372%
Industrial & Misc. Multi-class Mrtg./Asset Back Oblig.	10,000,927	1.740%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	9,955,251	1.732%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	8,521,561	1.482%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	6,724,316	1.170%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	5,993,807	1.043%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	5,258,940	0.915%
Public Utilities Unaffiliated Issuer Oblig.	5,050,557	0.878%
Industrial & Misc. U.S. Unaffiliated Issuer Oblig.	5,027,192	0.874%

The amounts and percentages of MSF's total admitted assets held in bonds by NAIC rating are:

	Amount	Percentage of Total Admitted Assets
NAIC-1	\$ 305,010,454	53.052%
NAIC-2	97,088,339	16.887%
NAIC-3	12,833,525	2.232%
NAIC-4	-	0.000%
NAIC-5	-	0.000%
NAIC-6	390,000	0.068%

The amount and percentage of admitted assets held in the largest 10 equity interests exceeding 2.5% of MSF's total admitted assets is:

Common Stock	\$64,180,639	11.163%
--------------	--------------	---------

The amount and percentage of the 10 largest investments included in the Write-ins for Invested Assets category included on the Summary Investment Schedule is:

Collateral Securities on Loan	\$57,563,169	10.012%
-------------------------------	--------------	---------

The MSF's admitted assets at June 30, 2002 are \$574,923,841.

ACCOUNTANT LETTER



A Professional Corporation of
Certified Public Accountants and Advisors

111 N Last Chance Gulch Helena MT 59601
PO Box 1684 Helena MT 59624

Phone: (406) 442-5520
Fax: (406) 443-4017

www.ghgcpa.com

INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Montana State Fund
Helena, Montana

We have audited the accompanying statements of admitted assets, liabilities and surplus (statutory basis) of Montana State Fund (New Fund), a component unit of the State of Montana, at June 30, 2002 and 2001, and the related statements of operations, changes in surplus and cash flows (statutory basis) for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note A, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of Montana, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to in the first paragraph present fairly, in all material respects, the admitted assets, liabilities, and surplus (statutory basis) of Montana State Fund for the years ended June 30, 2002 and 2001, and results of its operations, changes in surplus and cash flows (statutory basis) for the years ended June 30, 2002 and 2001 on the basis of accounting described in Note A.

However, because the company prepares its financial statements on a statutory basis of accounting, as discussed in the preceding paragraph, it is our opinion, that the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of Montana State Fund for the years ended June 30, 2002 and 2001 or the results of its operations, changes in surplus and cash flows for the years ended June 30, 2002 and 2001.

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
November 22, 2002

ACTUARIAL LETTER

Tillinghast - Towers Perrin

Robert F Conger
FCAS MAAA FCIA
Principals

One Atlantic Center
2000 Lenox Road, Suite 900
Atlanta, GA 30326-4230
404 365 1634
Fax 204 365 1663
E-mail: rfc@towers.tillinghast.com

November 18, 2002

To The Board of Directors of the Montana State Fund:

Tillinghast - Towers Perrin was engaged by the Montana State Fund (MSF) to estimate the unpaid loss and loss adjustment expenses as of June 30, 2002, for MSF's workers' compensation exposures. Our examination included the performance of independent projections of MSF's loss and loss expense liabilities and such other tests and procedures as we considered necessary in the circumstances. We relied on MSF personnel as to the completeness and accuracy of the data.

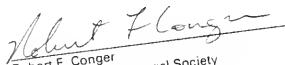
Our estimated loss and loss adjustment expense liability as of June 30, 2002, is \$343.5 million, undiscounted, and net of reinsurance recoverables. MSF has recorded a provision of \$346.4 million on its June 30, 2002 balance sheet for unpaid loss and loss adjustment expense.

In our opinion, the amounts recorded in the balance sheet as reserves for estimated loss and loss adjustment expense liabilities: (1) Are consistent with amounts calculated in accordance with commonly accepted actuarial methods and are fairly stated on an ultimate undiscounted basis in accordance with sound actuarial principles; (2) Are consistent with amounts based upon actuarial assumptions which are reasonable given the coverages provided; and (3) Make good and sufficient provision in the aggregate for all unpaid loss and loss adjustment expense obligations.

The Policyholders' Surplus of MSF as of June 30, 2002, is \$158.5 million, using statutory accounting principles. Current year premium revenue was \$93.0 million. We note that the Policyholders' Surplus level of MSF is consistent with traditional industry standards. We believe that it is prudent for MSF to set a long-term goal of maintaining appropriate surplus based on industry standards.

VARIABILITY

Loss and loss adjustment expense reserve estimates are subject to considerable uncertainty due to the fact that the ultimate liability for claims is subject to the outcome of events yet to occur. In evaluating whether the reserves make a reasonable provision for unpaid losses and loss expenses, it is necessary to project future loss and loss adjustment expense payments. Actual future losses and loss adjustment expenses will not develop exactly as projected and may, in fact, vary significantly from the projections.



Robert F. Conger
Fellow, Casualty Actuarial Society
Member, American Academy of Actuaries

S-48079-02PD CORRESPONDENCE OPINION BOARD 11/18/02 DDC

MANAGEMENT



Board of Directors



Carl Swanson
President/CEO
Ex-Officio



Derek Grewatz
Vice President
and Chief
Marketing Officer
Western States
Insurance,
Missoula



Herbert Leuprecht
Chairman, Butte
Business Owner



Wendy Susott
Banking Industry,
Missoula



Mark Cole
Trucking
Industry, Shelby



Susan Knedler
General Manager
Hi-Heat
Industries, Inc.
Lewistown



Lorretta Lynde
Helena
Management
Consulting



Tom Horn
Cohagen
Ranching,
Cohagen

Executive Team



Left to Right: **Laurence Hubbard** Vice President Insurance Operations,
Nancy Butler General Counsel, **Mark Barry** Vice President Corporate Support,
Linda Goan Special Assistant to the President, **Peter Strauss** Vice President
Insurance Operations Support.

The management of Montana State Fund (MSF) is responsible for the financial statements and all other information presented in this Annual Report. MSF maintains a system of internal control designed to provide reasonable assurance that assets are safeguarded against loss and that transactions are executed and recorded in accordance with management's authorization. This system encompasses the organizational structure, selection and training of personnel, communication and enforcement of policies and procedures, and ongoing internal and external audit programs. Internal controls are continually reviewed and evaluated by management.

The financial statements are presented for our fiscal year ending June 30, 2002 Annual Report and include amounts based on the best estimates and judgments of management. These financial results are presented on a statutory basis, which is consistent with insurance industry financial statement presentation. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the State of Montana, and its financial statements are presented on the basis of accounting practices prescribed or permitted by the Montana Insurance Department.

Galusha, Higgins & Galusha, an independent public accounting firm, audited and issued an unqualified opinion on MSF's statutory financial statements presented in this Annual Report. The preparation and independent external audit of statutory financial statements is discretionary on the part of MSF, but one that is seen as important, as evaluating the financial results of MSF in relation to other insurers aids in evaluating and maintaining the financial security and stability of MSF as a workers' compensation insurer. In addition, MSF is a component unit of the State of Montana. As required in law, the Legislative Audit Division (LAD) of the State of Montana conducts independent audits of financial statements of MSF presented in accordance with generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB). For the financial periods ending June 30, 2001 and 2002, MSF received an unqualified audit opinion from LAD. The audited governmental financial statements and the related audit opinion are issued under separate cover. To obtain a copy of the full governmental financial statements, contact the Legislative Audit Division.

The presentation of the statutory financial statements in this report differs from the governmental presentation basis (GASB). A financial reconciliation of surplus between the audited GASB financial statements and the audited statutory financial statements presented in this report is provided below.

A comparison of GASB to Statutory Accounting Ending Surplus for the year ended June 30, 2002 (in 000's):

Governmental Accounting (GASB) Ending Surplus	\$ 180,715
---	------------

Reconciling Items:

Unrealized Gain on Fixed Income Securities	2,107
Net Effect of Cumulative Unrealized Loss on Equity Securities	(9,819)
Net Effect of Cumulative Change in Non-Admitted Assets	(5,047)
Net Income difference between Methods	(9,457)

Statutory Accounting Ending Surplus	\$ 158,499
-------------------------------------	------------





5 South Last Chance Gulch
P.O. Box 4759
Helena, MT 59604-4759
800-332-6102 406-444-6500 406-444-7796 Fax
www.montanastatefund.com